



## Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Scott P. Johnson

**SUBJECT:** SEE BELOW

**DATE:** June 15, 2011

Approved

Date

6/16/11

**SUBJECT: APPROVAL OF THE CITY'S GOVERNMENTAL FUND BALANCE  
FINANCIAL REPORTING POLICY FOR EXTERNAL FINANCIAL  
REPORTING PURPOSES**

### RECOMMENDATION

Adopt a resolution approving a new City Council Policy entitled: "Governmental Fund Balance Financial Reporting Policy to comply with Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*."

### OUTCOME

Acceptance of these recommendations will provide direction and better equip staff to comply with the new financial reporting format and standards and continue to provide relevant financial information to the residents of San José, creditors, investors, and other interested parties. The implementation of GASB 54 will provide users of financial data an enhanced ability to determine available funds reserves which is one measure of a government's financial strength and flexibility. The adherence to and the existence of fund balance policies of a governmental reporting entity is viewed as a best practice by the credit rating agencies. This new financial reporting standard is anticipated to help clarify to the rating agencies and other users of financial data, the level to which the governmental entity commits to the types of local practices and priorities inherent in these policies. Furthermore, the implementation of GASB 54 will facilitate the ability to identify and evaluate policy changes over time. In addition, GASB 54 provides new definitions of governmental fund types and guidance concerning the types of activities and resources that should be reported in funds other than the General Fund.

## **BACKGROUND**

The Governmental Accounting Standards Board (GASB) was established in 1984 by agreement of the Financial Accounting Foundation (FAF) and ten (10) national associations of state and local government officials. GASB is the independent organization that establishes and modifies standards of accounting and financial reporting for U.S. state and local governments. GASB is recognized by governments, the accounting industry, and the financial markets as the official source of generally accepted accounting principles (GAAP) for state and local governments. The GASB is not a government entity; instead, it is an operating component of the FAF, which is a private entity. GASB standards are not federal laws or regulations nor does GASB have enforcement authority. Compliance with GASB's standards, however, is enforced through the laws of some individual states and through the audit process, when auditors render opinions on the fairness of financial statement presentations in conformity with GAAP. GASB periodically issues standards and other communication consistent with their mission statement, "*To establish and improve standards of state and local governmental accounting and financial reporting that will result in useful information for users of financial reports, and guide and educate the public, including issuers, auditors, and users of those financial reports.*" More information about GASB and its role can be found on the website at [www.gasb.org](http://www.gasb.org)

In March 2010, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. The objective of GASB 54 is to enhance the usefulness and the understandability of governmental fund balance information by providing clearer fund balance classifications that can be more consistently applied and therefore, making fund balances more understandable and transparent.

GASB 54 establishes fund balance classifications that establish a hierarchy based primarily on the extent to which a government is fiscally constrained based on the specific purposes for which monies in established funds can be spent. The Statement also clarifies the existing governmental fund type definitions to improve the comparability of governmental fund financial statements and assist financial statement users to better understand the purposes for which governments have chosen to use particular funds for financial reporting purposes. GASB 54 applies only to governmental funds (General Fund, Special Revenue Funds, Capital Project Funds, Debt Service Funds, and Permanent Funds) and not to the proprietary and fiduciary funds such as airport funds or retirement funds, respectively. Implementation of GASB 54 is effective for the City's fiscal year ending June 30, 2011.

It is important to note that the fund balance designations for financial reporting purposes will not necessarily align with the fund balance designations used for budgetary purposes. The City's Comprehensive Annual Financial Report (CAFR) will include a reconciliation between the two types of fund balance designations.

## **ANALYSIS**

The application of the GASB 54 will result in significant changes in the current financial reporting model of the City's governmental funds. Under previous reporting standards, the City's governmental fund balances were reported under three categories: reserved, unreserved, and designated. The new reporting standard replaces these three fund balance categories with five new classifications and establishes a hierarchy based on the extent to which spending constraints restrict how a government can use the funds. The five new classifications are:

- *Nonspendable Fund Balance*: includes amounts that are not in a spendable form, such as inventory, prepaid items, long-term interfund receivables, and amounts that are legally or contractually required to be maintained intact or required to be retained in perpetuity, such as the principal of an endowment fund.
- *Restricted Fund Balance*: includes amounts that can be spent only for the specific purposes stipulated by external resource providers.
- *Committed Fund Balance*: includes amounts that have been limited to specific purposes through City Council actions, such as adoption of a City Council policy.
- *Assigned Fund Balance*: includes amounts that have been allocated for specific purposes through City Council budgetary actions. It also applies to the remaining resources in any governmental fund other than the General Fund.
- *Unassigned Fund Balance*: includes amounts that do not fall into one of the above four categories. The General Fund is the only fund that should report this category of positive fund balance. In other governmental funds, if the expenditures incurred for specific purposes exceeded the amounts restricted, committed, or assigned to those purposes, it may be necessary to report a negative unassigned fund balances.

In addition to providing five new fund balance classifications, GASB 54 provides guidance on the establishment of Stabilization Arrangements and Funds ("Stabilization Funds"). Under GASB 54, Stabilization Funds that are established to cover revenue shortfalls, emergencies or other purposes should only be set aside/established by City Council action. As part of the formal Council action to create the funds, GASB 54 requires that Council must also identify and describe the special circumstances under which these funds can be used.

The City maintains four reserve funds in the General Fund: Contingency Reserve, Cash Reserve Fund (Earmarked Reserve), Economic Uncertainty Reserve and the Emergency Reserve Fund. The Cash Reserve Fund (Earmarked Reserve) and the Emergency Reserve Fund were established by the City Charter. The amount of funding in each reserve is subject to Council discretion. However, the City Charter established funds may not be rescinded nor have their purposes modified without voter approval.

As part of the GASB 54 implementation process, staff is recommending Council approval of a new Governmental Fund Balance Financial Reporting Policy (the "Policy") that sets forth the fund balance classifications for the City's governmental funds consistent with GASB 54. The establishment of this Policy will provide the necessary clarification on the terminology used in the fund balance classifications and assist with adhering to the external financial reporting requirements of GASB 54. See Attachment A for the new Governmental Fund Balance Financial Reporting Policy.

Staff has commenced preliminary analysis of funds impacted by the implementation of GASB 54 and potentially impacted funds will be consolidated either with the General Fund, other major funds, or reported under a different fund type. In order to remain in compliance with the new reporting standards, Finance staff will continue to review and analyze the various City funds and make necessary financial reporting modification to prepare financial statements for the fiscal period ending June 30, 2011. The final determination and reporting on the impacted funds will be done in conjunction with the preparation of the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2011.

#### **EVALUATION AND FOLLOW-UP**

Not Applicable

#### **PUBLIC OUTREACH**

Not Applicable

#### **COORDINATION**

This memorandum prepared by the Finance Department is in coordination with the City Manager's Budget Office and the City Attorney's Office.

#### **COST IMPLICATIONS**

There are no additional budgetary resources required to implement this accounting change.

Honorable Mayor and City Council

June 15, 2011

**Subject: New Governmental Fund Balance Financial Reporting Policy**

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**CEQA**

Not a Project, File No. PP10-068 (b), Municipal Code or Policy revision.

/s/

SCOTT P. JOHNSON

Director, Finance Department

For questions, please contact Scott P. Johnson, Director of Finance, at (408) 535-7000.

Attachment

## City of San José, California

### COUNCIL POLICY

TITLE	GOVERNMENTAL FUND BALANCE FINANCIAL REPORTING POLICY	PAGE  1 OF 4	POLICY NUMBER
EFFECTIVE DATE	REVISED DATE		
APPROVED BY COUNCIL ACTION			

#### PURPOSE

The purpose of the Governmental Fund Balance Financial Reporting Policy ("Policy") is to set forth the policy direction for the implementation of Governmental Accounting Standards Board Statement No. 54, ***Fund Balance Reporting and Governmental Fund Type Definitions*** which establishes a hierarchy of fund balance classifications which are based primarily on the extent to which the City is bound by constraints placed on resources.

#### POLICY

This Governmental Fund Balance Financial Reporting Policy sets forth the policy direction for the Finance Department's preparation of financial statements which accurately categorize fund balance in accordance with Governmental Accounting Standards Board ("GASB") Statement No. 54, ***Fund Balance Reporting and Governmental Fund Type Definitions*** ("GASB 54" or the "Statement"). The requirements of the Statement are effective for financial statements covering reporting periods beginning after June 15, 2010. The objective of the Statement is to improve the usefulness, including the understandability, of governmental fund balance information. This Policy establishes the new fund balance classifications for governmental funds for external financial reporting purposes such as in the City's Comprehensive Annual Financial Report. Certain commitments and assignments of fund balance will help ensure there will be adequate financial resources to protect the City against unforeseen circumstances and events such as revenue shortfalls and unanticipated expenditures. The fund balance disclosures, consistent with GASB 54, provides more clearly defined categories to make the nature and extent of the limitations placed on the City's fund balance more transparent. The increased transparency provides users of the financial statements information necessary to understand the processes under which constraints are imposed upon the use of resources and how those constraints may be modified or eliminated.

#### FUND BALANCE DEFINITION

Fund Balance is defined as the excess of total assets as compared to total liabilities in a governmental fund. As defined by GASB 54, the financial statement reporting for governmental funds will classify fund balances based primarily on the extent to which the government is bound to honor constraints on the specific purpose for which those fund can be spent.

#### FUNDS TYPES DEFINITION

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Governmental funds are used to account for governmental activities. Governmental funds are classified as the following: General Fund, Special Revenue Funds, Capital Project Funds, Debt Service Funds, Permanent Funds and specifically excludes proprietary and fiduciary funds. For purposes of GASB 54, only governmental funds will be required to be classified under the new fund balance classifications. The classification of proprietary funds and fiduciary funds will not be affected by the implementation of GASB 54.

## **GOVERNMENTAL FUND TYPE DEFINITIONS**

GASB 54 provides further clarification on the use of various governmental fund types: General Fund, Special Revenue Funds, Capital Projects Funds, Debt Service Funds, and Permanent Funds.

- **General Fund:** Account for and report all financial resources not accounted for and reported in another fund.
- **Special Revenue Funds:** Account for and report the proceeds of specific revenue sources that are:
  1. Restricted or committed to expenditure for specified purposes other than debt service or capital projects.
  2. Proceeds of specific revenue sources establish that one or more specific restricted or committed revenues should be the foundation for a Special Revenue Fund. The specific restricted or committed revenues may be initially received in another fund and subsequently distributed to a special revenue fund.
  3. The restricted or committed proceeds of specific revenue sources should be expected to continue to comprise a substantial portion of the inflows reported in the fund.
  4. Other resources (investment earnings and transfers from other funds, for example) also may be reported in the Special Revenue Fund if those resources are restricted, committed, or assigned to the specified purpose of the fund.
  5. Special Revenue Funds should not be used to account for resources held in trust for individuals, private organizations, or other governments.

Notes to the financial statements should disclose the purpose for each major Special Revenue Fund including identifying which revenues and other resources are reported in each of the Special Revenue Funds.

- **Capital Projects Funds:** Account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets.
- **Debt Service Funds:** Account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest. Debt service funds should be used to report resources if legally mandated. Financial resources that are being accumulated for principal and interest maturing in future years should be reported in Debt Service Funds.

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- **Permanent Funds:** Account for and report financial resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the City's programs for the benefit of the City and residents.

## **NEW FUND BALANCE CLASSIFICATIONS**

GASB 54 outlines the requirement to report the fund balance for governmental funds in specific classifications which create a hierarchy primarily based on the extent to which the City is bound to the constraints on the specific purposes for which funds can be spent.

- **Nonspendable Fund Balance:** Amounts that are not in a spendable form, such as inventories, prepaid items, and long-term receivables. It also includes amounts that are legally or contractually required to be maintained intact or required to be retained in perpetuity, such as the principal of an endowment fund.
- **Restricted Fund Balance:** Amounts reported as restricted when constraints placed on use of resources are either (1) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments; or (2) imposed by law through constitutional provisions or enabling legislation.
- **Committed Fund Balance:** Amounts that have been limited to specific purposes as defined in the City Charter or through a formal budgetary action of the City Council occurring through adoption of an ordinance or resolution. These commitments may be changed or lifted, but only by the same formal action that was used to impose the constraint originally. City Council action to commit fund balance must occur within the fiscal reporting period while the amount committed may be subsequently determined.
  - **Highest Level of decision making authority** – City Council
  - **Formal Action Required to Establish/Modify/Rescind** – City Council resolution or ordinance or voter approval in the case of modifying or rescinding funds established in the City Charter.
- **Assigned Fund Balance:** Amounts that are intended to be used for specific purposes through City Council budgetary actions. For all governmental funds other than the General Fund, any remaining positive amounts not classified as nonspendable, restricted or committed must be designated as Assigned Fund Balance.
  - **Body/Official Authorized to Assign Amounts** – City Council through budget adoption and amendments
  - **Policy Established by City Council to Delegate Authorization** – “Governmental Fund Balance Financial Reporting Policy”, however no delegation is provided.
- **Unassigned Fund Balance:** Amounts within the General Fund, the residual resources, either positive or negative, in excess of what can be properly classified in one of the other four fund balance categories. Within all other governmental funds, the negative residual resources in excess of what can be properly classified as nonspendable, restricted, or committed.



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## **ORDER OF FUNDS SPENDING**

The City will spend the most restricted dollars in accordance with restrictions imposed before less restricted in the following order:

- a. Nonspendable
- b. Restricted
- c. Committed
- d. Assigned
- e. Unassigned

## **STABILIZATION ARRANGEMENTS AND FUNDS**

Stabilization Arrangements and Funds ("Stabilization Funds") can be established for items such as revenue shortfalls, emergencies or for covering unplanned budgetary imbalances. The Stabilization Funds are restricted to the controls that dictate the circumstances under which they can be spent.

For the purpose of reporting fund balance under GASB 54, stabilization is considered a specific purpose and to which the government is bound to honor constraints on the specific purposes or circumstances for which amount in those funds can be spent. The City has set aside the amounts currently listed as Contingency Reserve, Cash Reserve Fund, and Emergency Reserve Fund in the General Fund. These reserves may be reported as part of the Committed Fund Balance in accordance with GASB 54 provided that the following requirements are met:

- **Highest Level of decision making authority** – City Council
- **Formal Action Required to Establish/Modify/Rescind** – City Council resolution or ordinance. With respect to the Cash Reserve Fund or the Emergency Reserve Fund, they can only be modified or rescinded by amendments to the City Charter.
- **Parameters for Establishment** – Established through formal City Council action which describes the specific circumstances under which need for Stabilization Fund arises and parameters for spending funds. In the case of the Cash Reserve Fund and the Emergency Reserve Fund they are established by City Charter (Section 1212 and Section 1213, respectively)

**Any changes or the removal of the reserve balances and any modifications to the specified use will require the same type of formal action taken to establish the reserve balance.**